

*Example 4. Debt instrument with a capped variable rate.* On July 1, 1995, A sells nonpublicly traded property to B in return for a debt instrument with a stated principal amount of \$10,000,000, payable on July 1, 2005. Interest is payable on July 1 of each year, beginning on July 1, 1996, at the Federal short-term rate for June of the same year. The debt instrument provides, however, that the interest rate cannot rise above 8.5 percent, compounded annually. Assume that, as of the date the test rate of interest for the debt instrument is determined, the Federal short-term rate is 8 percent, compounded annually. Assume further that, as a result of the interest rate cap of 8.5 percent, compounded annually, the expected yield of the debt instrument is significantly less than the expected yield of the debt instrument if it did not include the interest rate cap. Under paragraph (f)(1)(ii) of this section, the variable payments are treated as contingent payments for purposes of this section.

(i) [Reserved]

(j) *Special rules for tax-exempt obligations*—(1) *Certain variable rate debt instruments.* Notwithstanding paragraph (b) of this section, if a tax-exempt obligation (as defined in section 1275(a)(3)) is a variable rate debt instrument (within the meaning of §1.1275-5) that pays interest at an objective rate and is subject to section 1274, the issue price of the obligation is the greater of the obligation's fair market value and its stated principal amount.

(2) *Contingent payment debt instruments.* Notwithstanding paragraphs (b) and (g) of this section, if a tax-exempt obligation (as defined in section 1275(a)(3)) is subject to section 1274 and §1.1275-4, the issue price of the obligation is the fair market value of the obligation. However, in the case of a tax-exempt obligation that is subject to §1.1275-4(d)(2) (an obligation that provides for interest-based or revenue-based payments), the issue price of the obligation is the greater of the obligation's fair market value and its stated principal amount.

(3) *Effective date.* This paragraph (j) applies to debt instruments issued on or after August 13, 1996.

[T.D. 8517, 59 FR 4821, Feb. 2, 1994, as amended by T.D. 8674, 61 FR 30141, June 14, 1996]

### § 1.1274-3 Potentially abusive situations defined.

(a) *In general.* For purposes of section 1274, a potentially abusive situation means—

(1) A tax shelter (as defined in section 6662(d)(2)(C)(ii)); or

(2) Any other situation involving—

(i) A recent sales transaction;

(ii) Nonrecourse financing;

(iii) Financing with a term in excess of the useful life of the property; or

(iv) A debt instrument with clearly excessive interest.

(b) *Operating rules*—(1) *Debt instrument exchanged for nonrecourse financing.* Nonrecourse financing does not include an exchange of a nonrecourse debt instrument for an outstanding recourse or nonrecourse debt instrument.

(2) *Nonrecourse debt with substantial down payment.* Nonrecourse financing does not include a sale or exchange of a real property interest financed by a nonrecourse debt instrument if, in addition to the nonrecourse debt instrument, the purchaser makes a down payment in money that equals or exceeds 20 percent of the total stated purchase price of the real property interest. For purposes of the preceding sentence, a real property interest means any interest, other than an interest solely as a creditor, in real property.

(3) *Clearly excessive interest.* Interest on a debt instrument is clearly excessive if the interest, in light of the terms of the debt instrument and the creditworthiness of the borrower, is clearly greater than the arm's length amount of interest that would have been charged in a cash lending transaction between the same two parties.

(4) *Debt-for-debt exchange*—(i) *Rule.* A debt instrument issued in a debt-for-debt exchange, including a deemed exchange under §1.1001-3, will not be treated as the subject of a recent sales transaction for purposes of section 1274(b)(3)(B)(ii)(I) even if the debt instrument exchanged for the newly issued debt instrument was recently acquired prior to the exchange. Therefore, the issue price of the debt instrument will not be determined under section 1274(b)(3). However, if the debt instrument or the property for which the debt instrument is issued is publicly traded within the meaning of §1.1273-

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2(f), the rules of § 1.1273-2 will apply to determine the issue price of the debt instrument.

(ii) *Effective/applicability date.* Paragraph (b)(4)(i) of this section applies to a debt instrument issued on or after November 13, 2012.

(c) *Other situations to be specified by Commissioner.* The Commissioner may designate in the Internal Revenue Bulletin situations that, although described in paragraph (a)(2) of this section, will not be treated as potentially abusive because they do not have the effect of significantly misstating basis or amount realized (see § 601.601(d)(2)(ii) of this chapter).

(d) *Consistency rule.* The issuer's determination that the debt instrument is or is not issued in a potentially abusive situation is binding on all holders of the debt instrument. However, the issuer's determination is not binding on a holder who explicitly discloses a position that is inconsistent with the issuer's determination. Unless otherwise prescribed by the Commissioner, the disclosure must be made on a statement attached to the holder's timely filed Federal income tax return for the taxable year that includes the acquisition date of the debt instrument. See § 1.1275-2(e) for rules relating to the issuer's obligation to disclose certain information to holders.

[T.D. 8517, 59 FR 4822, Feb. 2, 1994, as amended by T.D. 9599, 77 FR 56538, Sept. 13, 2012]

### § 1.1274-4 Test rate.

(a) *Determination of test rate of interest—(1) In general—(i) Test rate is the 3-month rate.* Except as provided in paragraph (a)(2) of this section, the test rate of interest for a debt instrument issued in consideration for the sale or exchange of property is the 3-month rate.

(ii) *The 3-month rate.* Except as provided in paragraph (a)(1)(iii) of this section, the 3-month rate is the lower of—

(A) The lowest applicable Federal rate (based on the appropriate compounding period) in effect during the 3-month period ending with the first month in which there is a binding written contract that substantially sets forth the terms under which the sale or exchange is ultimately consummated; or

(B) The lowest applicable Federal rate (based on the appropriate compounding period) in effect during the 3-month period ending with the month in which the sale or exchange occurs.

(iii) *Special rule if there is no binding written contract.* If there is no binding written contract that substantially sets forth the terms under which the sale or exchange is ultimately consummated, the 3-month rate is the lowest applicable Federal rate (based on the appropriate compounding period) in effect during the 3-month period ending with the month in which the sale or exchange occurs.

(2) *Test rate for certain debt instruments—(i) Sale-leaseback transactions.* Under section 1274(e) (relating to certain sale-leaseback transactions), the test rate is 110 percent of the 3-month rate determined under paragraph (a)(1) of this section. For purposes of section 1274(e)(3), related party means a person related to the transferor within the meaning of section 267(b) or 707(b)(1).

(ii) *Qualified debt instrument.* Under section 1274A(a), the test rate for a qualified debt instrument is no greater than 9 percent, compounded semiannually, or an equivalent rate based on an appropriate compounding period.

(iii) *Alternative test rate for short-term obligations—(A) Requirements.* This paragraph (a)(2)(iii)(A) provides an alternative test rate under section 1274(d)(1)(D) for a debt instrument with a maturity of 1 year or less. This alternative test rate applies, however, only if the debt instrument provides for adequate stated interest using the alternative test rate, the issuer provides on the face of the debt instrument that the instrument qualifies as having adequate stated interest under section 1274(d)(1)(D), and the issuer and holder treat or agree to treat the instrument as having adequate stated interest.

(B) *Alternative test rate.* For purposes of paragraph (a)(2)(iii)(A), the alternative test rate is the market yield on U.S. Treasury bills with the same maturity date as the debt instrument. If the same maturity date is not available, the market yield on U.S. Treasury bills that mature in the same week or month as the debt instrument is